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No. 479

In the Supreme Court of the United States

OCTOBER TERM, 1940

NORMAN J. PFAFF and FRANK B. WALLACE, Executors of Estate of William L. Wallace, Dec'd,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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For the Second Circuit

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vs.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

Laurence Sovik, Esq., on behalf of Norman J. Pfaff and Frank B. Wallace, Executors of the Estate of William L. Wallace, deceased, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit, entered in the above entitled action on July 8th, 1940.

OPINIONS BELOW

The opinion of the Board of Tax Appeals was a memorandum opinion (Fols. 31-41) and was not officially reported. The decision of the Circuit Court of Appeals was reported at 113 Fed. (2d.) 114. It likewise was a memorandum decision.

JURISDICTION

The jurisdiction of this Court to review this decision is derived from Section 240 of the Judicial Code as amended (28 U. S. C. A., §347), wherein this Court is authorized upon the petition of any party to require by certiorari either before or after a judgment or decree by such lower court, that the cause be certified to the Supreme Court for determination by it, with the same power and authority and with like effect as if the cause had been brought there by unrestricted writ of error or appeal.

This case involves the interpretation of Section 42 of the Revenue Act of 1934.

The decision which petitioners seek to have reviewed was handed down by the Circuit Court of Appeals for the Second Circuit on July 8, 1940.

STATEMENT

On August 30, 1937, the Commissioner notified petitioners that he had determined a deficiency in the tax return filed by petitioners for decedent for the year 1935 (Fols. 15-27). Petitioners duly filed a petition to the United States Board of Tax Appeals for a redetermination of the deficiency (Fols. 8-14) and a hearing thereon was had before Board Member J. Russell Leech, Esq., at Buffalo, N. Y., on June 20, 1939. On Sept. 30, 1939, a decision was rendered by Hon J. Russell Leech, affirming the Commissioner's determination (Fol. 42). Petitioners thereupon duly filed a petition for review by the United States Circuit Court of Appeals for the Second Circuit (Fols. 43-54). The appeal was argued before the Circuit Court, and on July 8, 1940, a decision was handed down, affirming without opinion the decision of the Board of Tax Appeals (Fol. 178).

Decedent, William L. Wallace, was a member of a partnership of practicing physicians. On July 1, 1933, decedent and several other physicians and surgeons entered into a partnership agreement (Ex. 1, Fols. 137-149) under which they operated until June 30, 1935. At that time the old partnership was dissolved and a new partner taken in and a new partnership agreement made, under which decedent and his associates operated until Dec. 25, 1935, when decedent died (Ex. 2, Fols. 150-165). Both of said partnerships were maintained on a cash basis, as were also the books of decedent (Fol. 95).

Petitioners filed an income tax return for the year 1935, the year in which decedent died, including therein all sums which decedent had received or was entitled to from the partnerships, according to the partnership agreements. In assessing the deficiency against petitioners, the Commissioner claimed that in decedent's return for 1935 they should have included his share of the estimated receipts from all cases which the partners were then treating, in spite of the fact that the monies had not been received by the partnership and that many of the cases were not completed or fees thereon fixed at the time of the decedent's death.

Some of these cases were completed during 1936 and the fees due were collected by the surviving partners. Decedent's share of the sums so collected, amounting to $5,189.19, was paid over to decedent's estate by the surviving partners during 1936 (Fols. 134, 135). On Oct. 1, 1936, decedent's interest in the uncollected accounts was sold at public auction, pursuant to order of the Surrogate of Onondaga County, for $500 (Ex. 3, Fol. 166).

The partnership agreement specifically provided that the partnership accounts should be maintained on a cash basis and that a partner was not entitled to share in the proceeds of cases

being treated until the fees had been collected and partnership expenses paid therefrom. Thus paragraph Eighth (Fols. 143, 158) of the agreements (Exs. 1 and 2) provide that on the first day of each month there shall be an accounting for the preceding month of—

> "all partnership gains and losses and there shall be paid to each of said partners, after the deduction of the expenses of said partnership, the proportionate share of the profits of said co-partnership, as hereinbefore specified."

And paragraph Sixth (Fols. 142, 157) of the agreements (Exs. 1 and 2) provide that the books of account of the partnership shall contain a record of—

> "all money by them or either of them received, paid out or expended in and about said business."

No entries were made on the partnership books until the money for the particular service had been received by the partnerships (Fols. 94, 96). A record of services to patients was maintained on a card system (Fol. 98). As services were rendered an entry was made on one of these cards to show the time and amount of service performed (Fols. 98, 100). No bills were sent out until the case was completed (Fol. 98), and in many cases no charge was ever made and no bill ever sent (Fol. 99). Upon the completion of the case, the physician partner in charge thereof, made a flat charge for the entire case and a bill was then sent out to the patient (Fols. 96, 100).

The books of the partnership showed only expenditures actually made and cash actually received (Fol. 95). The monthly accounts had, pursuant to paragraph Eighth of each of the partnership agreements, referred only to the cash transactions appearing on the books.

It is petitioners' contention that the Commissioner erred in holding that the value of the cases under treatment by the various partners constituted income to decedent which might be accrued under Section 42 of the Revenue Act.

THE QUESTION PRESENTED

Whether the unallocated share of a partner in the prospective receipts from services performed by the partnership prior to his death constitutes income to decedent which may be accrued under Section 42 of the Revenue Act of 1934, when both the deceased partner and the partnership maintain their books on a cash basis.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, C. 277, 48 Stat. 680:

"Sec. 4. The application of the General Provisions and of Supplements A to D, inclusive, to each of the following special classes of taxpayers, shall be subject to the exceptions and additional provisions found in the Supplement applicable to such class, as follows:

(a) Estates and trusts and the benficiaries thereof, Supplement E.

(b) Members of partnerships,—Supplement F.

(c) Insurance companies,—Supplement G.

(d) Nonresident alien individuals,—Supplement H.

(e) Foreign corporations,—Supplement I.

(f) Individual citizens of any possession of the United States who are not otherwise citizens of the United States and who are not residents of the United States,—Supplement J.

(g) Individual citizens of the United States or domestic corporations, satisfying the conditions of Section 251 by reason of deriving a large portion of their

gross income from sources within a possession of the United States,—Supplement J.

(h) China Trade Act corporations,—Supplement K." (U. S. C., Title 26, §4.)

"Sec. 42. Period in which items of gross income included.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayers, unless, under the methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period (U. S. C., Title 26, Sec. 42)."

"Sec. 181. Partnership not taxable.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity (U. S. C., Title 26, Sec. 181)."

"Sec. 182. Tax of partners.

There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year (U. S. C., Title 26, Sec. 182)."

Treasury Regulations, 86, relating to the Revenue Act of 1934, Art. 42-2, provides:

"Income not reduced to possession—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is

subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition * * *."

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that decedent's share in the prospective receipts for services rendered by the partnership of which he was a member prior to the date of his death but not then received either by the partnership nor by the partner, should be considered income to decedent in year 1935 accruable within the meaning of Section 42 of the Revenue Act of 1934.

2. In failing to hold that decedent's share in the prospective receipts for services rendered by the partnership of which he was a member prior to the date of his death but not then received either by the partnership nor by the partner, did not constitute income to decedent in year 1935.

3. In affirming the decision of the Board of Tax Appeals.

REASONS RELIED UPON FOR WRIT

1. The decision of the Circuit Court of Appeals for the Second Circuit, affirming the commissioner's action in assessing the deficiency against petitioners, conflicts with the decisions of other Circuit Courts of Appeal.

By its memorandum opinion in the instant case, reported at 113 Fed. (2d) 114, the Second Circuit Court of Appeals held that petitioners were required to report as decedent's income during 1935 his share of the accounts due the partnership of which he was a member, even though the partnership had not collected these accounts, nor allocated to any partner his particular share, and in many instances the services had not been completed.

The Commissioner of Internal Revenue, in making this assessment, relied upon §42 of the Revenue Act of 1934, which provides in part:

> "In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death amounts accrued up to the date of his death if not otherwise properly includable in respect of such period or a prior period."

The Commissioner contends that this section authorized him to include in decedent's income for the year 1935 the value of the cases then being treated by the partnership of physicians of which decedent was a member. Some of these accounts were collected during 1936; decedent's interest in the balance was sold at auction during that year. The partnership kept its accounts on a cash basis, as did decedent. The partnership agreements expressly provided that the individual partners should receive from the partnership only their respective shares of the cash received.

In making the assessment the Commissioner interpreted §42, which provides for the accrual of the income of a deceased taxpayer up to the date of his death, to require the accrual

of the income of a partnership of which decedent was a member, even though the partnership had maintained its accounts on a cash basis.

The Commissioner's interpretation was sustained by the Board of Tax Appeals in a memorandum decision which was affirmed by the Circuit Court of Appeals for the Second Circuit at 113 Fed. (2d) 114. This decision by the Circuit Court is in direct conflict with the decision reached by the Circuit Court of Appeals for the Third Circuit in an almost identical case, *Enright's Estate vs. Commissioner of Internal Revenue*, 112 Fed. (2d) 919.

In that case decedent was a member of a partnership of lawyers which kept its accounts and made its tax returns on a cash receipts and disbursements basis. Their partnership agreement provided for the annual determination of the earnings to be distributed to the partners on the basis of cash receipts and disbursements. Decedent likewise made his returns on a cash basis. Decedent's distributable interest in the partnership cash was reported by his executors in the return filed subsequent to his death. The Commissioner added to decedent's taxable income his interest in the collectible accounts receivable of the firm and in fees earned in whole or in part not yet billed or received from clients, contending the same to be amounts accrued up to the date of his death and taxable in the year of his death. The Commissioner was sustained by the Board of Tax Appeals. The Circuit Court of Appeals for the Third Circuit, however, reversed, stating:

> "The Board said in its memorandum opinion that the effect of the provision of Section 42 of the Revenue Act which we have quoted above 'was to require that deceased be placed upon an accrual basis at the

date of his death. We agree that this was its effect. It follows that the decedent's taxable income should have been computed in the same way it would have been had he been alive and regularly making his returns on the accrual basis.

We think the Board fell into error in failing to treat the partnership as a tax computing unit separate from its member, Enright. That the Revenue Act requires that a partnership be so treated is clear from its provisions for the computing of partnership income and the filing of partnership returns and has been recognized by the courts. Thus a partnership may make its returns for a taxable year different from that of its members, and it may likewise make its returns upon an accounting basis different from that used by the individual partners."

The similarity between the above case and the case at bar is clear. The decision reached by the respective Circuit Courts are clearly at variance. Rule 38, subdivision 5(b) sets out as one of the bases for granting certiorari a decision of a Circuit Court of Appeals in conflict with the decision of another Circuit Court of Appeals on the same matter. This Court has likewise granted certiorari many times in cases where the decisions of Circuit Courts of Appeal conflict. (*Aschenbrenner v. U. S. F. & G. Co.*, 292 U. S. 80, 82; *Stroehmann v. Mutual Life Insurance Co.*, 300 U. S. 435, 440.) Mr. Chief Justice Taft stated in *Magnum Co. v. Coty*, 262 U. S. 159, 163:

"The jurisdiction to bring up cases by certiorari from the Circuit Courts of Appeal was given for two purposes, first to secure uniformity of decision between those courts and the nine Circuit Courts, and,

second, to bring up cases involving questions of importance which it is in the public interest to have decided by this Court of last resort."

Petitioners contend, therefore, that in order to secure uniformity of decision among the various Circuit Courts of Appeal this Court should grant a writ of certiorari in the present case.

2. The Circuit Court of Appeals for the Second Circuit has herein decided an important question of federal law which has not been but should be settled by this court.

The instant case is one of the first arising under the amendment which was added to Section 42 of the Revenue Act of 1934.

A decision by this Court upon this point is essential in view of the numerous cases in which this statute is and will be involved. Upon the decision in this case will rest the determination of the tax to be assessed against members of countless partnerships throughout the United States. Among professional men the partnership is the prevalent form of business association. To include as income to the deceased member of a partnership his respective share of the accounts of the partnership, whether collected or not, whether the work has been completed or not, would be to impose upon such taxpayer a burden certainly not intended by Congress in enacting the amendment in question.

Petitioners contend that the income intended to be reached by this statute is that which has accrued to decedent, not that which has accrued to the partnership of which he is a member.

That Section 42 of the Revenue Act was not intended to be interpreted as the Commissioner has done is clear from the very arrangement of the statute itself.

By the terms of Section 4, the general provisions of the Act are declared subject to special provisions in the Act for certain classes of taxpayers. Section 42, the interpretation of which is herein involved, is included in the title "General Provisions." Section 182 is the special provision for partnerships to which we are referred by Section 4.

By the terms of Section 182 the net income of a partner is to include his distributive share of the partnership income for the year. Reference to paragraphs "Sixth" and "Eighth" of the partnership agreements (Fols. 142, 143, 157, 158) shows that the individual partner had no distributive share in the partnership income until collection had been made, expenses paid and monthly accounts completed. Paragraph "Thirteenth" (Fols. 147, 162) provides that upon termination of the partnership, the proceeds should be distributed as they were collected. Decedent, therefore, had no distributive share in the proceeds upon the dissolution of the partnership until collection had been made, according to the terms of the agreements.

The distinction between partnership income and individual partner's income for tax purposes has been made many times by the courts. It has been held that the Government cannot levy upon partnership assets because of a tax claim against an individual partner (*U. S. v. Kaufman*, 267 U. S. 408); a partner cannot offset personal non-capital losses against his distributive share of partnership non-capital gains (*Johnston v. Commissioner*, 86 Fed. (2d) 732); the partners and their partnership can have different fiscal years (*Guaranty Trust Co. v. Commissioner*, 303 U. S. 493), and the partners and their partnership

can have different methods of accounting (*Truman v. U. S.*, 4 F. Supp. 447; *Percival H. Truman*, 3 B T A 386; *W. J. Burns*, 12 B T A 1209; *Fritz Hill*, 22 B T A 1079).

Petitioners further contend that there was no income accruable to decedent as claimed by the Commissioner. In this regard this Court stated in *Guaranty Trust Co. v. Commissioner*, 303 U. S. 493:

> "Receipt of income or accrual of the right to receive it within the tax year is the test of taxability, not the time it has taken the taxpayer to earn it, nor the duration of his investments which have finally resulted in profit. *Lucas v. Alexander*, 279 U. S. 573.
>
> The Revenue Acts have consistently adhered to that policy in taxing the income of a partner. Since the partner is entitled to profits only upon a partnership accounting at the end of the accounting period, his profits become subject to income tax when and as they are thus ascertained."

Unless the income was actually received by decedent before his death, or the right to receive it had accrued to him at that time, under the rule in *Guaranty Trust Co. v. Commissioner*, supra, it was not taxable during that tax year. The Commissioner makes no contention that decedent received the income during 1935, nor that he was entitled to receive it; he maintains that under the foregoing sections it became taxable accrued income to taxpayers as of the date of decedent's death.

Other cases reaching the same conclusion are: *Simms Oil Co. v. Commissioner*, 74 Fed. (2d) 561; *Helvering v. Russian Finance and Construction Corp.*, 77 Fed. (2d) 324; *H. Liebes v. Commissioner*, 90 Fed. (2d) 932.

In *Commissioner v. Edwards Drilling Co.*, 95 Fed. (2d) 719, the Circuit Court for the Fifth Circuit reviewed several decisions of this Court, stating:

> "It is, of course, true as the Board points out that under the accrual method of accounting employed by petitioner, items must be accrued as income when the events occurred to fix the amount due and determine liability to pay. *United States v. Anderson,* 269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347. Generally speaking, however, the income tax law is concerned, and its administration should deal only, with, realized losses, and realized gains. *Lucas v. American Code Co.,* 280 U. S. 445, 50 S. Ct. 202; 74 L. Ed. 538, 67 A. L. R. 1010. The taxpayer therefore is under no obligation to pay a tax on income he might never receive. *North American Oil Consolidated v. Burnet,* 286 U. S. 417, 52 S. Ct. 613, 76 L. Ed. 1197. A strained construction in administrative efforts to accrue income should be avoided."

Article 42-2 of Treasury Regulation 86 and which provides for the computation of income not reduced to possession, declares that to constitute income to the taxpayer, it must be credited or set apart to him without substantial limitation or restrictions and made available to him to be drawn upon at any time.

An analogy in support of the holding sought by petitioners is found in decisions involving the return of income impounded pending disposal of litigation. In one such case, *North American Oil Consolidated v. Burnet,* 286 U. S. 417, the court held impounded income taxable in the year in which it was actually received. Brandeis, J., stated:

"The net profits were not taxable to the company as income of 1936 * * *. There was no constructive receipt of the profits by the company in that year, because at no time during the year was there a right in the company to demand that the Receiver pay over the money. Throughout 1916, it was uncertain as to who would be declared entitled to the profits. It was not until 1917, when the District Court entered a final decree vacating the Receivership and dismissing the bill, that the Company became entitled to receive the money. Nor is it material for the purposes of this case, whether the company's return was filed on cash receipts and disbursements basis or on the accrued basis. In neither event was it taxable in 1916 on account of income which it had not yet received and which it might never receive."

Although the Commissioner claims that his interpretation of Section 42 does not constitute taxing as income to decedent his share of the partnership assets, that is exactly what it amounts to in the case of a partnership of professional men. In such cases the chief asset of a partnership, aside from the individual abilities of the various partners, are the accounts. These accounts cannot under the cases previously cited be considered income for the reason that they are neither definitely ascertainable nor capable of distribution to the members of the partnership.

In the light of the foregoing cases, this question of Federal Law is clearly of the greatest importance and has not yet been settled by this Court.

CONCLUSION

It is therefore respectfully submitted that for the reasons above stated this petition for writ of certiorari should be granted.

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